REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
greg@growmydollar.com
www.growmydollar.com

Sep. 21, 2017 No. 315

OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

Last month, we explored the topic of luck in investing. This month, we will consider one of the better performing companies in the stock market for the last two years. It is currently the fourth largest company in the S&P 500 by market value, and has gained 80% in market value, verses 30% for the S&P 500 since 2015. A reasonable question to ask is: Could you have seen that coming, or was it just luck? The company is Amazon.

Amazon has been wildly successful; however, great companies do not always make great investments. A further examination of Amazon suggests that its recent investment success is at least partly due to luck. Suppose you are able to see the future, and you decide if Amazon's stock price was predictable or not. If you were given the company's financial results in 2015 for the next two years, would you have predicted the company would have increased in market value by 80%?

The revenue for Amazon in 2015 ended the year at $107 billion. The estimates for 2017 are that the company will have $170 billion in sales. That is a gain of 65%, a stock price gain of 80% doesn't seem that unreasonable. Earnings in 2015 were $1.50, the estimates for 2017 are for the company to earn $3.90. That's a 160% increase, maybe the stock should have gone up by more than 80%. It is never that simple. In 2015, the stock was $300 a share, so that means that you were paying 200 times the then current earnings. In 2015, you only had to pay $20 for $1 of earnings for the stock market. The real challenge is that you would have had to predict that Amazon was going to become the fourth most valuable company in the market, something in the past that has only happened to highly mature and profitable companies. In addition, you had to anticipate that investors are still going to pay $250 for $1 dollar of earnings! That is Amazon's present valuation. Another viewpoint is that if you owned the whole company, your current return is .4%. But you say: Amazon is taking over the world! Let us examine that prediction.

The current earnings estimates are for profits to grow by 57% for the next five years. If you are an Amazon investor, you had better hope so. If they do, earnings will then be up to $38 in 2022. With today's price of $965, you are still paying 25 times the earnings of $38 that you will wait five years to get. So, for you to earn 10% per year on Amazon, the stock most go up 60%. At $1550, you are again predicting that investors will pay 40 times earnings five years from now. This doesn't even consider that the company doesn't issue anymore equity to pay for their expansion of acquiring the world. Any investor willing to pay $40 for $1 of earnings, demands a lot of growth going forward. So now we are up to Amazon having a value of over $1 trillion, which means it is 5% of the current economy. So, to review, investors must pay 40 times Amazon's earnings in 2022, and its market value will be over $1 trillion. Now anything can happen, especially when you mix luck into the equation, but this doesn't even address the assumption that the rest of the economy is just going to roll over and let Amazon destroy them. Someone told me recently: "From an investor point of view it is hard for me to see the benefit of one company destroying the profitability of a huge number of companies without generating profit itself."

The lesson to be learned here is that sometimes you do get lucky, especially if you have owned Amazon for the last two years. Just don't confuse a great company with a great investment. If you are thinking that you are only worried about the next six months and that 28 analysts have the stock rated a buy, 13 outperform, and only 1 has the stock rated a sell, you really are hoping for some luck. Because the track record of analysts in general is that they are way too high on their earnings estimates almost all the time.